MICHAEL J. MURPHY
State Treasurer

Second Quarter 2003

The QUARTERLY

Local Government Investment Pool

Hoping for a second half economic recovery

The second quarter of calendar year 2003 gave investors more of the same mixed signals about the economy. However, the market heard more commentaries about disinflation/ deflation probability due to the economy's anemic performance.

What worries most economists is the specter of sub-par growth in an environment where deflation has been remotely considered. With all the smoke signals this quarter, most investors are certain that interest rates will stay at these levels for a longer time until solid economic numbers are generated in the future.

The Federal Reserve, during its June meeting, signified there are two main risks threatening the U.S. economy. The FOMC said "... the upside and downside risks to the attainment of sustainable growth for the next few quarters are roughly equal." Its outlook on inflation also was disturbing: "... the probability, though minor, of an unwelcome substantial fall in inflation exceeds that of a pickup in inflation from its already low level."

These statements suggest that even the Federal Reserve policy makers do not have a clear handle on which direction the economy will go, judging from all the data it has examined. The Fed, however, has indicated it will leave rates low even if growth re-accelerates in order to lessen the excess capacity plaguing the economy.

There are improvementsto be seen on the economic landscape, except for the most critical area – job creation. June's unemployment rate reached a nine-year high of 6.4 percent. The US economy has now lost roughly 400,000 jobs for the first half of 2003. This heightens the continued vulnerability of the economy. The Federal Reserve expects the jobless rate to average about 6.00-6.25 percent by the end of 2003. Next year, the rate should go back down to an average of 5.50-6.00 percent.

Consumer outlays have continued to support the market due to the buoyancy of both home sales and mortgage refinancing. According to Fed Chairman Greenspan, the housing boom has been the source of consumer wealth in a slow economy. During his twice-yearly testimony to congress, Greenspan said most business activity was confined to balance sheet restructuring due to a low interest rate environment. Most companies have been reluctant to expand capital outlays due to the current business uncertainty.

The Federal Reserve said it is hopeful the effects of both tax cuts and low interest rate environment will aid the economy to regain its footing. The Fed targets GDP next year to be in a range between 3.75-4.75 percent, which assumes a gradual pickup in economic activity. However, their economic growth forecast for this year has been revised downward to 2.50-2.75 percent from 3.00-3.25 percent. The ongoing cautiousness of companies to invest fresh capital and their reluctance to hire new workers was cited as the reason for this decline.

The stock market continued to build on gains made during the first quarter of 2003. The S&P 500 and the Dow Jones posted 11.76 percent and 7.72 percent gains, respectively, while the NASDAQ gained 21.82 percent for the same period. The conclusion of the Iraq war and the improving outlook for corporate earnings sustained the gains made during the first quarter of this year. Cost-cutting measures and productivity gains by workers were twin contributors to the better-than-expected earnings results of publicly traded companies. Investors are optimistic that consumer confidence will bounce back quickly as easier credit conditions and the administration's fiscal stimulus will create a retail friendly environment. Retail sales rose 0.5 percent in June, the biggest jump during the second quarter.

The bond market had a brief bounce in May after a lackluster performance during the first quarter. The expectations of a more aggressive interest rate cut by the Federal Reserve supported a bond rally up to the June 25 FOMC announcement. However, the rally stalled after the FOMC cut the funds rate by only 25 basis points (bp), from 1.25 percent to 1.00 percent. Investors were disappointed as 25 bp was viewed as far too conservative to stave off any signs of disinflation. The yield curve steepened immediately after the rate

continued on page 2

LGIP staff

Michael J. Murphy
State Treasurer
(360) 902-9001

Michael Colleran
Assistant Treasurer
(360) 902-9002

Douglas Extine
Deputy Treasurer
(360) 902-9012

Lisa Hennessy
Investment Officer
(360) 902-9013

Jen Thun
LGIP Administrator
1-800-331-3284

Mary Pheasant
Administrative Support
(360) 902-9004

www.tre.wa.gov

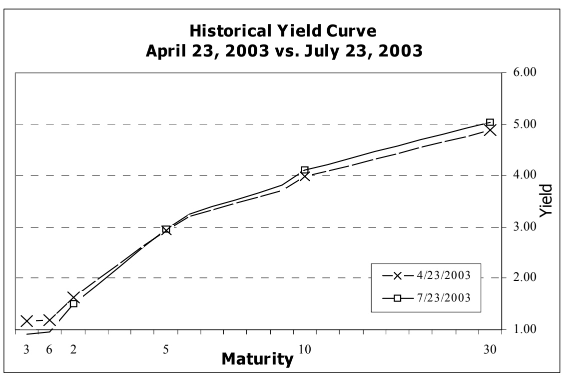
Market summary

from page 1

cut, an indication of investors' dissatisfaction. For the period beginning April 23 - July 23, the yields on three-month and six-month bills dropped by 25 and 23 bp, respectively, while 2-year note yields were 13 bp less and 3-year notes dropped by 11 bp. In contrast, the yield on the 5-year and 10-year notes increased by 1 bp and 13 bp, respectively. Investors sold longer-dated securities as a protection from the Federal Reserve's forecast of a second half economic recovery.

The net return on the LGIP ranged from 1.24 percent to 1.23 percent in April and May respectively, to 1.19 percent in June. On June 25 the FOMC cut the targeted fed funds rate to 1 percent. The LGIP net rate, closely linked to the fed funds rate, is likely to work its way toward 1 percent in the coming months.

Predominant market sentiment is that the FOMC will hold rates steady for the time being. The average life of the LGIP portfolio is currently 60 days, representing a neutral stance with regard to FOMC and interest rate activity. The portfolio is positioned to shift with any changes in the general attitude of the market.



Notes from the July LGIP advisory meeting

The LGIP Advisory Committee met July 25. A brief update was given on the net LGIP returns for January through June 2003. The LGIP net rate ranged from 1.29 percent in March to 1.19 percent in June. The late June easing by the Fed lowered the fed funds rate to 1.00 percent. Accordingly, the LGIP rate will be drifting lower with the net rate for July estimated to be about 1.10 percent. Despite the economic conditions of the state, the LGIP balance has remained relatively high and is currently at $4.9 billion.

Two new advisory members were appointed for three year terms which expire on April 30, 2006. They are Barbara Stephenson, Kitsap County Treasurer, appointed by Treasurer Murphy; and, Virginia "Jenny" Zacher, Franklin County Treasurer, appointed by the Washington State Association of County Treasurers (WSACT). Two members were also reappointed for three-year terms expiring on April 30, 2006. They are Lynn Hills, Port of Bremerton, reappointed by the Washington Public Ports Association; and, Shelley Pearson, Kitsap County Investment Officer, reappointed by the Washington Municipal Treasurers Association (WMTA).

The current strategy for the management of the LGIP portfolio was discussed. Given the current level of interest rates, and with the expectation that the fed is on hold for awhile, the average life of the portfolio will remain in a neutral range. Advisory committee members then participated in a dialogue regarding the present status of the market, their cash balances and the economic outlook of their entities.

The Fiscal Year 2003 budget was reviewed utilizing a handout provided to committee members. The actual fees collected were higher than estimated, due to a higher than anticipated LGIP balance, with expenses also being slightly higher. The rebate for FY 2003 of approximately $1.17 million will be about $170,000 higher than originally estimated. The net expenses for the fiscal year amount to about one basis point. A chart was distributed showing the history of the LGIP participants' average investment balance and administrative expenses data for FY 1998 – FY 2003.

A brief update was given and a handout was distributed regarding the Public Finance track that OST has developed for the WFOA conference to be held in September 2003.

The Government Finance Officers Association has awarded the Certificate of Achievement for Excellence in Financial Reporting to the LGIP for the Comprehensive Annual Financial Report (CAFR) for the fiscal year ended June 30, 2002.

A brief overview of the accounting procedures and process used for putting together the CAFR was given by the OST accounting

continued on page 3

LGIP Advisory Committee

Stan Finkelstein
Assn. of Washington Cities
(360) 753-4137

Chuck Greenough
State Board for Community and Technical Colleges
(360) 704-4380

Paula Henderson
City of Des Moines
(206) 870-6512

Lynn Hills
Port of Bremerton
(360) 674-2381

Richard Patrick
City of Burlington
(360) 755-0531

Shelley Pearson
Kitsap Co. Investment Offcr.
(360) 337-7139

Barbara Stephenson
Kitsap County Treasurer
(360) 337-7136

Kathy Turnbull
San Juan County Treasurer
(360) 378-2171

Dan Underwood
City of Richland
(509) 942-7302

Mark Wyman
Snohomish County PUD
(425) 783-8317

Linda Wolverton
Spokane County Treasurer
(509) 477-3674

Virginia "Jenny" Zacher
Franklin County Treasurer
(509) 545-3518

Holiday Schedule 2003

Monday, September 1
Labor Day

Monday, October 13
Columbus Day

Tuesday, November 11
Veteran's Day

Thursday/Friday
November 27/28
Thanksgiving holiday

Thursday, December 25
Christmas Day

Welcome new LGIP participants
Help us in thanking and congratulating new LGIP participants who have become members in the second quarter of 2003:

South Puget Sound Community College

Also offered by the Office of the State Treasurer. . .

LOCAL Program
Financing solutions for local government equipment and real estate needs.

www.tre.wa.gov/local.htm

Contacts:
Sue Melvin
Equipment specialist
360-902-9022

Kristi Wolgamot
Real estate specialist
360-902-9020

Pam Johnson
LOCAL specialist
360-902-9021

Investment policy certification: What's keeping you?

The Washington Municipal Treasurers Association (WMTA) established its Investment Policy Certification Program in 1988. Since then, 77 policies have been certified under this program. Congratulations to those entities that took the time to develop and implement their investment policies. Surprisingly, fewer than 50 percent of the cities in Washington with populations over 10,000 – and just over half of the counties – have investment policies certified either by WMTA or the Association of Public Treasurers (APT).
… So, what's keeping you?

Developing policies and procedures is a time-consuming process and, understandably, it's usually not a high priority. However, a sound investment policy can be tremendously valuable in managing your investment program. You wouldn't send someone on an errand without clear directions, nor would you enter into a competitive game without knowing the rules. So why would you attempt to safely invest public funds without the guidelines and direction of an investment policy? An investment policy defines your program's objectives. It protects investment staff and provides a clear picture of investment goals to your governing board and brokers/dealers. A well-developed investment policy is the foundation for a successful investment program.

The WMTA Investment Policy Certification Program is designed to provide professional assistance in developing or revising investment policies. A model policy for entities to use as an example and guidelines for compliance with WMTA standards are available through the program. Sample policies can provide helpful guidance, but it is important that each entity tailor its investment policy and program to its specific and unique needs.

When an investment policy is submitted for certification it is first assessed for completeness. It is then distributed to three reviewers who evaluate the investment policy and make a recommendation about certification. To be certified by WMTA, the three reviewers must reach a consensus. Entities are notified of the status of their investment policy in approximately four weeks. Should an investment policy be denied certification, reviewers will offer suggestions to help in meeting WMTA standards. The entity may then modify its policy and resubmit it without further charges. Entities whose investment policies are certified receive a plaque and are recognized at the WMTA Annual Conference.

While an investment policy should be able to stand the test of time and not waver with the whims of the market, it's a good idea to review it regularly. New investment opportunities or cash flow changes may call for revisions to the policy. In any case, an investment policy should be reviewed at least every two years to ensure it continues to meet the needs of the investment program, and to make certain the portfolio is consistent with stated guidelines and procedures. If you find your investment policy requires major modifications, it may be a good idea to have it recertified once those changes are made.

If you have any questions about the Investment Policy Certification Program, or would like a model policy and application packet mailed to you, contact Lisa Hennessy, Investment Policy Certification Chair, at (360) 902-9013 or lisa@tre.wa.gov. A model policy, guidelines, and application are also available online at www.wmta-online.com/Invest.html.

Minutes

from page 2

division. The external auditor, Peterson Sullivan, PLLC, will be starting its field work in August and the report will be published in November.

The director of accounting services stated that the investments portion of TM$ is now fully implemented and discussed other aspects of TM$ as it relates to the interface between OST and local governments.

A meeting date in October will be selected and committee members will be notified of that date.

Investing 101:
Gap analysis and the implied forward rate

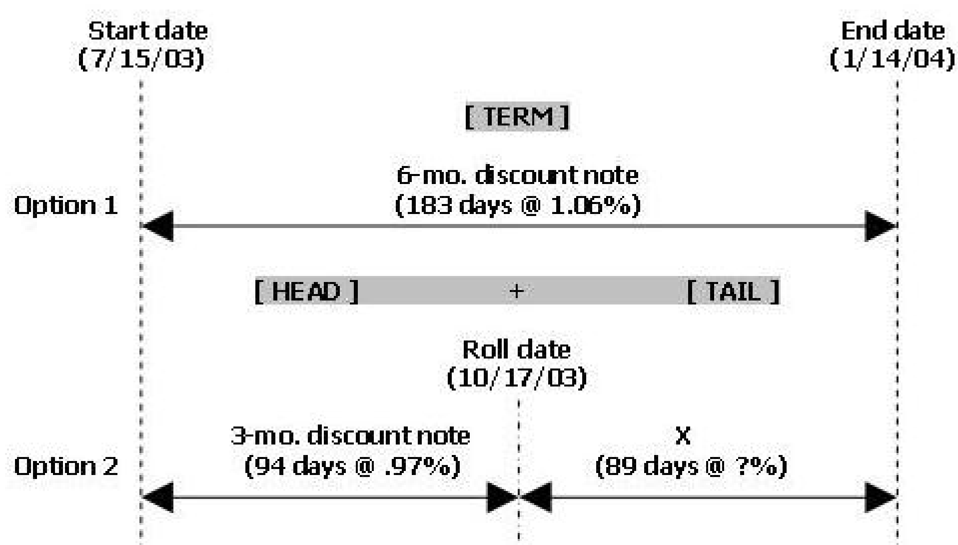
The following article is part of the "Investing 101" educational series, which focuses on basic investment issues. We hope you find these articles informative and helpful. If you have comments or would like to suggest other topics for the series, please call Lisa Hennessy at (360) 902-9013.

Gap analysis can be defined as a mathematical evaluation of short-term funding strategies for money market instruments on a breakeven basis. More simply, it's a means of comparing two short-term investments versus an equivalent longer term investment. The analysis ultimately results in an *implied forward rate.*

As a practical example of gap analysis, suppose we have surplus cash that will not be needed for cash flow purposes for six months. There are several options for investing those funds for the 6-month time period; one 6-month security, two 3-month securities, six 1-month securities, etc., or the money could even be deposited into the LGIP for six months. As a portfolio manager, you want to choose the option with the greatest earning potential, but how can you compare them? Gap analysis is an algebraic tool that, when combined with your interest rate outlook, allows you to make a more informed decision as to the best investment option for a specific time period.

Let's consider the first two options listed above, i.e., one 6-month security or two 3-month securities. For our example, **Option 1** will be a discount note that yields 1.06% and matures 1/14/04. **Option 2** will be a discount security yielding .97% and maturing 10/17/03, followed by another discount security that settles 10/17/03 and matures 1/14/04. We know that **Option 1** will earn 1.06% for the entire six month period. **Option 2** will earn .97% over the first three months, but what about the remaining three months?

The success of **Option 2** over **Option 1** depends on the earnings rate of the second 3-month security, but we have no way of knowing for sure what that future rate might be. However, using gap analysis we can determine a breakeven rate. The result of our analysis will be the rate we must earn when it comes time to purchase the second 3-month security to at least equal what we would earn by purchasing the 6-month security. Let's picture our options:



continued on next page

The full investment period, from the start date of July 15 to the end date of January 14, is the "Term." We'll refer to the period from July 15 to the first maturity, or roll date, as the "Head," and from the roll date to the end of the term will be the "Tail." Now we can formulate a mathematical equation to determine the rate at which we must reinvest when our 3-month security matures to equal the earnings of the 6-month investment:

HEAD + TAIL = TERM
solving for the Tail:
TAIL = TERM – HEAD

First we calculate the known values, the "Term" and "Head":

TERM = (rate x #days from Start to End)
= (1.06 x 183)
= 193.98

HEAD = (rate x #days from Start to Roll date)
= (.97 x 94)
= 91.18

Now we can calculate the "Tail":

TAIL = 193.98 – 91.18
= 102.80

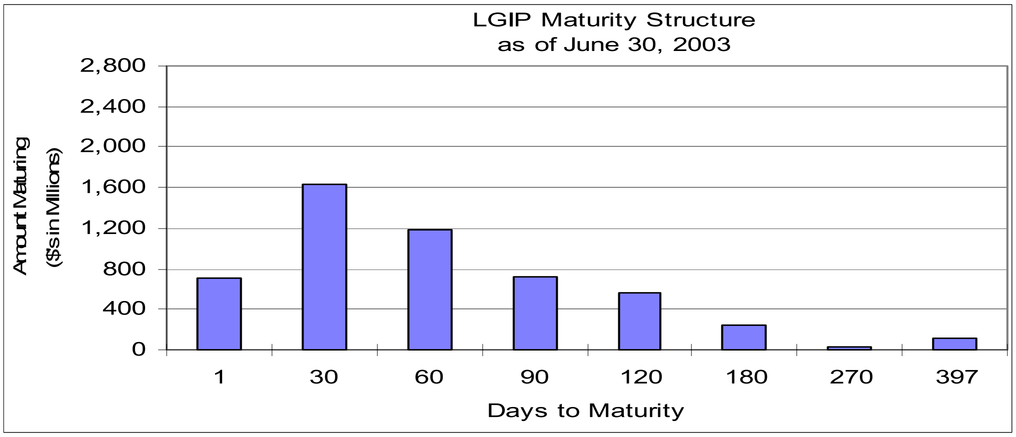
Finally, we convert the "Tail" to a rate:

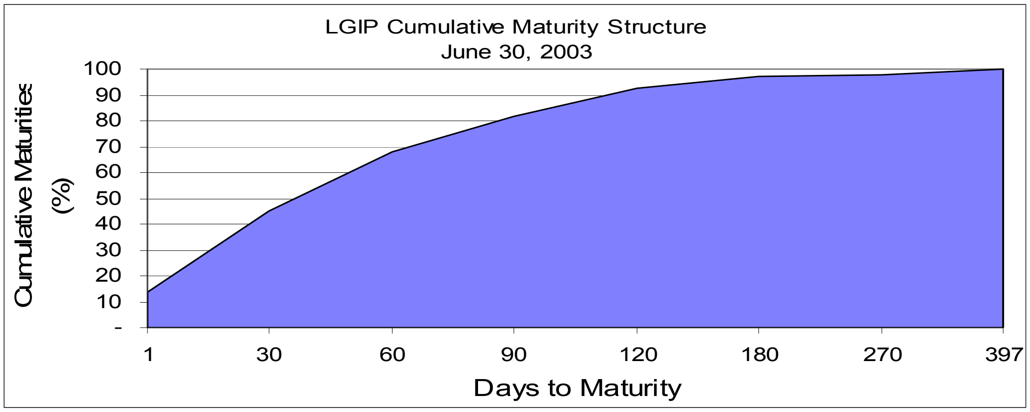
Rate = (TAIL / #days from Roll date to End)
= (102.80 / 89)
= **1.16%**

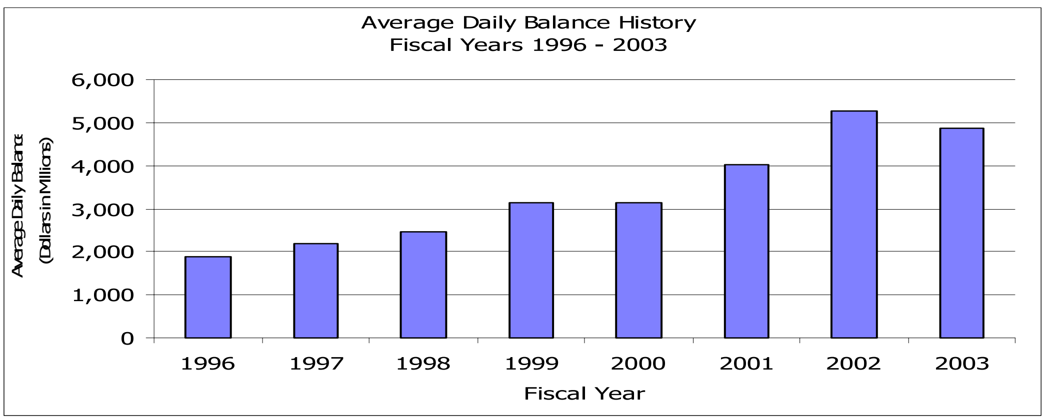
The "Tail" tells us that if we purchase the 3-month security yielding .97%, we must be able to reinvest at a rate of 1.16% at maturity to equal what we would earn if we purchase the 6-month security. This resulting rate represents the *implied forward rate*. In other words, the market expects that, three months from now, the rate on a 3-month security will be 1.16%.

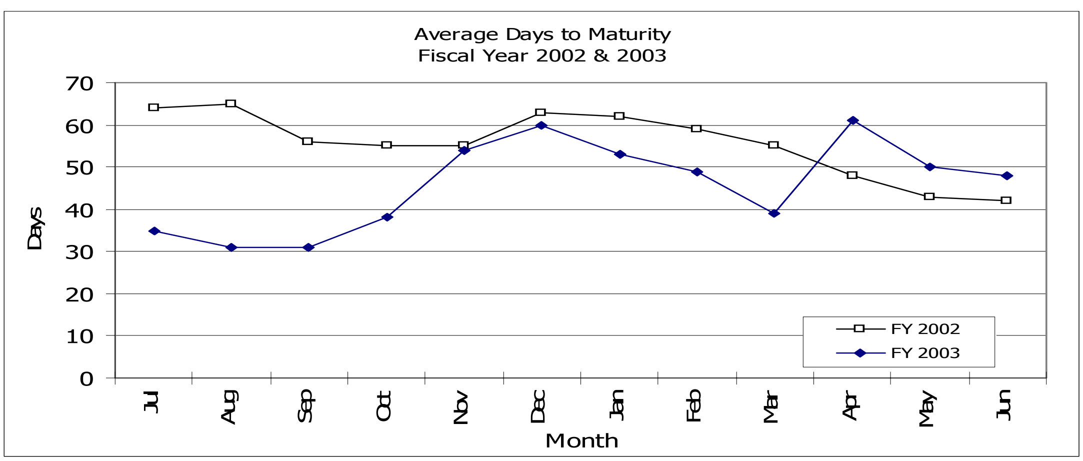
But what do you think? Consider, if you purchase a 3-month security in July, the Federal Open Market Committee (FOMC) will meet at least two times before the security matures. What is your interest rate outlook — do you think the FOMC will ease, tighten, or keep the targeted fed funds rate the same? If you think rates will fall, purchasing the 6-month security and locking in a higher interest rate seems wise. However, if your sentiment is that rates are likely to rise, it makes more sense to purchase the 3-month security in anticipation of a higher reinvestment rate at maturity.

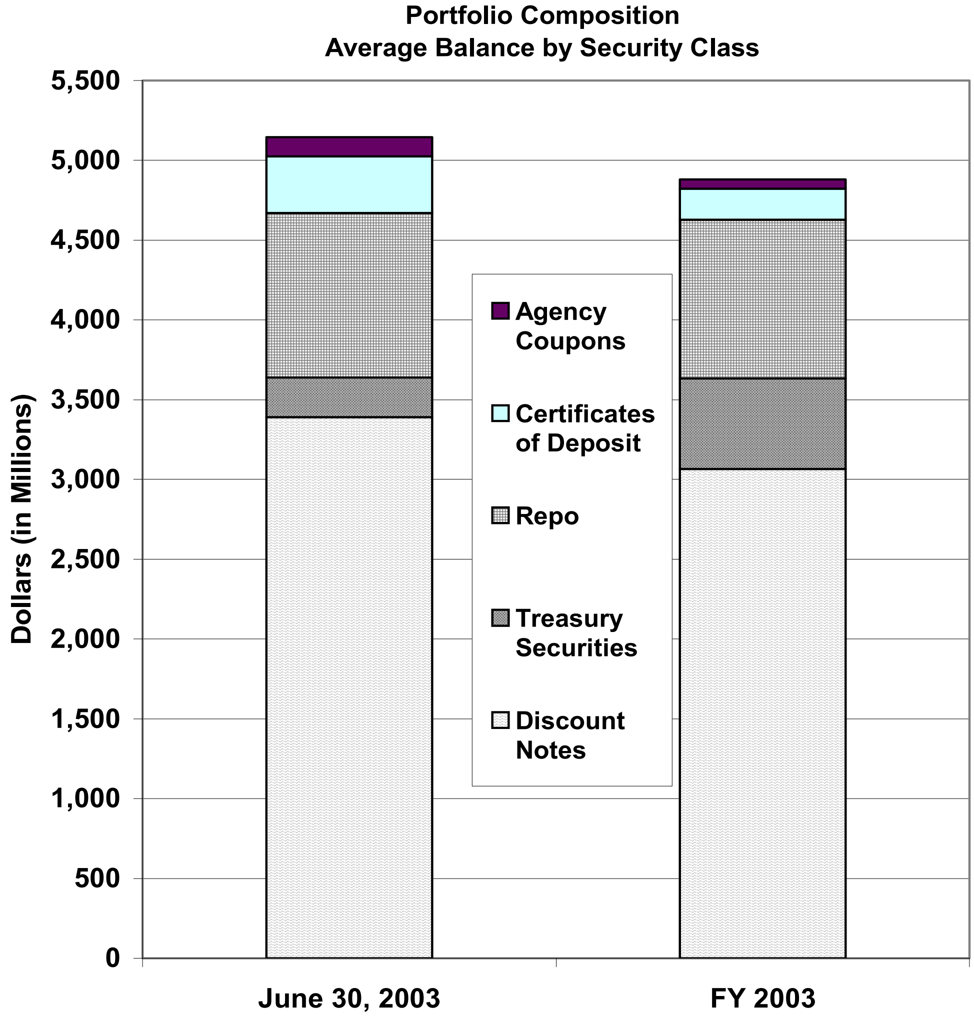
Clearly, gap analysis can be very useful in evaluating potential trades and assessing the market. Earlier in this article we mentioned the LGIP as one of the options for that six-month investment of surplus funds. Gap analysis is more complicated when the LGIP is one of the options being evaluated. In our next article, we'll discuss gap analysis using the LGIP as an option.


LGIP Maturity Structure
as of June 30, 2003
Amount Maturing
($s in Millions)
2,800
2,400
2,000
1,600
1,200
800
400
0
1
30
60
90
120
180
270
397
Days to Maturity

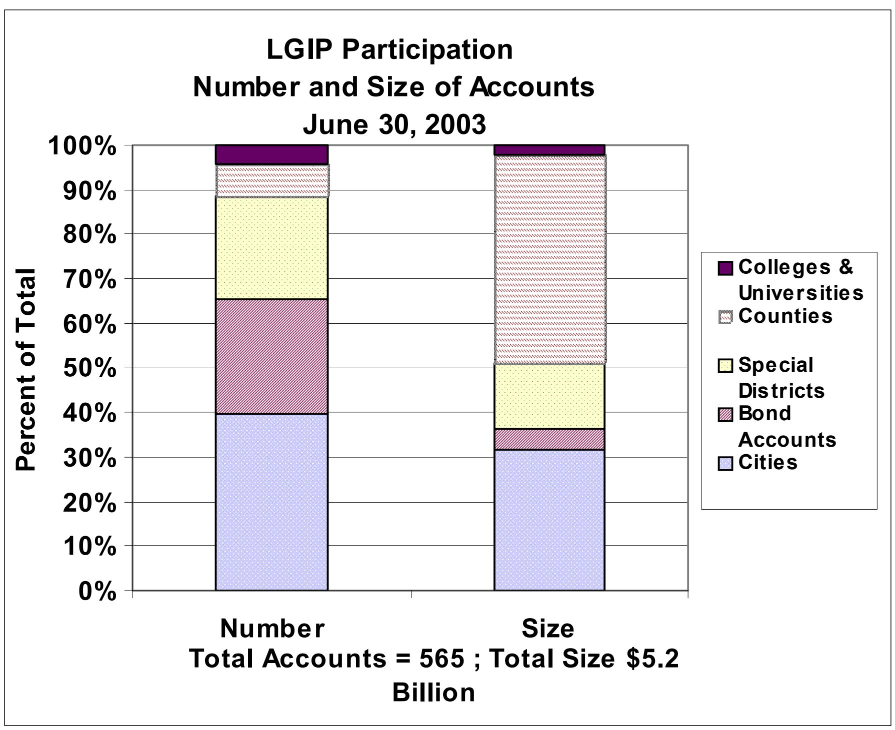

LGIP Cumulative Maturity Structure
June 30, 2003
Cumulative Maturities
(%)
100
90
80
70
60
50
40
30
20
10
-
1
30
60
90
120
180
270
397
Days to Maturity


Average Daily Balance History
Fiscal Years 1996 - 2003
Average Daily Balance
(Dollars in Millions)
6,000
5,000
4,000
3,000
2,000
1,000
0
1996
1997
1998
1999
2000
2001
2002
2003
Fiscal Year


Average Days to Maturity
Fiscal Year 2002 & 2003
Days
70
60
50
40
30
20
10
0
FY 2002
FY 2003
Jul
Aug
Sep
Oct
Nov
Dec
Jan
Feb
Mar
Apr
May
Jun
Month



Portfolio Composition
Average Balance by Security Class
5,500
5,000
4,500
4,000
3,500
3,000
2,500
2,000
1,500
1,000
500
0
Dollars (in Millions)
Agency Coupons
Certificates of Deposit
Repo
Treasury Securities
Discount Notes
June 30, 2003
FY 2003



LGIP Participation
Number and Size of Accounts
June 30, 2003
100%
90%
80%
70%
60%
50%
40%
30%
20%
10%
0%
Percent of Total
Colleges & Universities
Counties
Special Districts
Bond Accounts
Cities
Number
Size
Total Accounts = 565 ; Total Size $5.2 Billion

WFOA 2003 PUBLIC FINANCE TRACK

Don't miss WFOA 2003! Within our Public Finance track we've designed a comprehensive program focusing on portfolio management skills. Here is a preview of the sessions we're offering:

Economic Update – Are We Out of Purgatory Yet?
John Mitchell, US Bank

The US economy has been growing since the end of 2001, but the growth rate has not been enough to tighten labor markets significantly. The Washington economy declined for two years as the tech/telecom collapse coincided with an aerospace decline and the fallout from rising energy prices. The prospects for the nation and the state for the balance of 2003 and 2004 will be discussed.

Interest Rates – Are They High or Low?
Mike Colleran, Office of the State Treasurer

This session will try to answer that question by looking at long- and short-term interest rates from a historical perspective. How do rates today compare with rates at other times in U.S. history? What caused major changes in the direction of interest rates in the past may provide clues as to what will cause such changes in the future.

The LGIP and Establishing a Plan for Investments
Lisa Hennessy, Office of the State Treasurer

This session will help participants understand the key principles in managing the LGIP portfolio and gain insight into managing their own short-term portfolios. We'll discuss the most efficient use of the LGIP as an investment option (with regard to interest rate environment), managing average life, and gap analysis.

Portfolio Management 1 – Laying the Foundation of an Investment Program
Douglas Extine, Office of the State Treasurer

"Groundwork" information for establishing an investment program. Eligible investments, developing investment policies, custody and settlement issues, and the value of competition in your investment program will be discussed. Participants will learn about the yield curve, portfolio management strategies, and the value of meaningful performance benchmarks.

Portfolio Management 2 – Tools for Analyzing Trades
Deanne Woodring and Dave Westcott, D.A. Davidson & Co.

This session will prepare participants for building and evaluating a portfolio by providing decision-making tools for analyzing trades. Using a sample portfolio, specific trade ideas will be analyzed and rationale presented as to whether or not the trades fit within the portfolio strategy.

Portfolio Management 3 – Building / Evaluating a Portfolio
Deanne Woodring and Dave Westcott, D.A. Davidson & Co.

A "hands-on" culmination of Portfolio Management 1 and 2. Participants will use the groundwork and tools provided in previous sessions to analyze and form their own rationale as to whether or not to include potential trades in a sample portfolio. The session will include group discussion and evaluation of potential trades.

continued on page 10

Washington State Local Government Investment Pool
Position and Compliance Report
as of 06/30/2003
(Settlement Date Basis)

LGIP Portfolio Holdings

		Cost	Percentage of Portfolio
Agency Bullets	$	173,399,088	3.35
Certificate of Deposit		110,150,000	2.13
Discount Notes		3,491,754,746	67.48
Liquidity Deposits (MIA)		267,236,161	5.16
Repurchase Agreements		903,626,000	17.46
U.S. Treasuries		228,209,154	4.41
***Total Excluding Securities Lending**	$	5,174,375,148	100.00

Securities Lending Holdings

	Cost
	143,940,964
Total Securities Repurchase Agreements	143,940,964

Total Investments & Certificates of Deposit $ 5,318,316,113

Policy Limitations

*The policy limitations include investment of cash collateral by a securities lending agent calculated as percentages of the portfolio holdings Total Excluding Securities Lending.**

Size Limitations

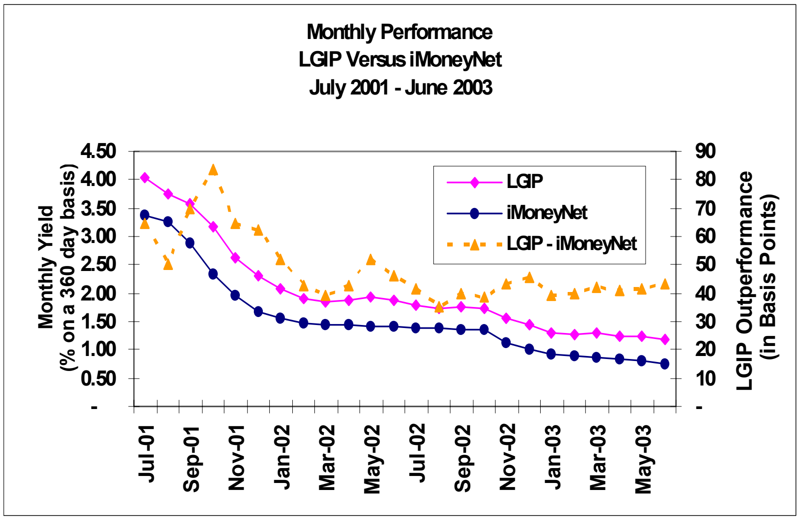
	Portfolio Holdings	Percentage	Policy Percentage
Certificate of Deposit	110,150,000	2.13	10%
Leverage - Sec Lend + Rev Repo	140,214,106	2.71	30%

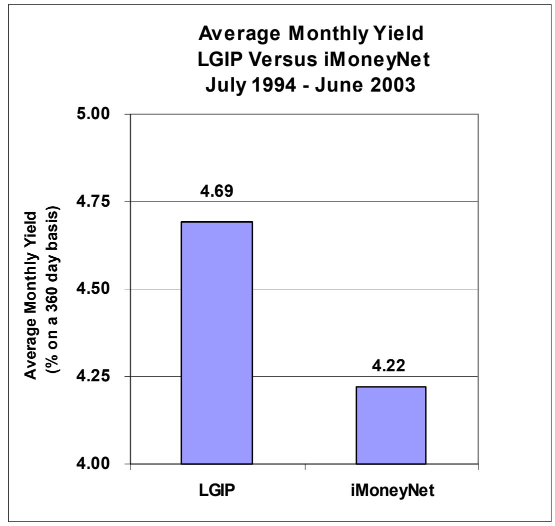
Maturity Limitations (Days)	Currently	Policy
Average Life	48	90
Maximum Maturity	336	397
Maximum Maturity of Repos	2	180
Maximum Maturity of Reverse Repos	0	90
Average Life of Reinvestment of Cash by Lending Agent	1	14

Repo Limits Per Dealer	June 30, 2003	Total Repo Percentage (20% limit)	Term Repo Percentage (10% limit)	Projected Redemptions 7/1/2003	Projected Position 7/1/2003
Banc America Securities	500,000,000	9.66%	0.00%	500,000,000	-
Banc One Capital Mkts	100,000,000	1.93%	0.00%	100,000,000	-
Goldman Sachs	321,296,178	6.21%	3.87%	121,296,178	200,000,000
Lehman Brothers Inc.	28,626,000	0.55%	0.00%	28,626,000	-
Merrill Lynch	75,000,000	1.45%	0.00%	75,000,000	-
Morgan Stanley Dean Witt	22,644,786	0.44%	0.00%	22,644,786	-
Total	**1,047,566,964**			**847,566,964**	**200,000,000**

LGIP Performance Comparison

iMoneyNet, Inc. [1]
versus
Local Government Investment Pool





The chart on the left shows a monthly comparison from July 2001 through June 2003 and how the LGIP has consistently outperformed the benchmark.

The chart on the right shows an average monthly yield comparison from July 1994 to June 2003. The LGIP net rate of return has outperformed its benchmark during that time period by an average of 47.2 basis points. This translates into the LGIP earning $134.27 million over what the average comparable private money fund would have generated.

[1] Average Net Rate of Return of Government Only/Institutional Only Money Market Funds, Money Market Insight, iMoneyNet, Inc., Westborough, MA. This benchmark is comprised of privately managed money market funds similar in composition and investment guidelines to the LGIP.

WFOA 2003 Public Finance Track

from page 8

What We Should Teach Elected Officials about Finance

The Honorable Michael J. Murphy

The care and feeding of commissioners/council members/mayors is critical to professionals in the public treasury. If we can help them understand what we do, how we do it, and why we do it, they will have the information they need to make decisions that best support our programs and benefit our organizations.

Freddie Mac

George Bentley, Freddie Mac

The trends and issues currently being faced by the Government Sponsored Enterprises (GSEs) will be addressed, with a special emphasis on the unique political environment in which they operate. Freddie Mac's operations and the range of debt products they offer will be discussed.

Local Government Investment Pool

STATEMENT OF NET ASSETS
June 30, 2003

Assets		
Investments, at Amortized Cost:		
Repurchase Agreements		903,626,000
U.S. Agency Coupons		173,399,088
U.S. Agency Discount Notes		3,491,754,746
U.S. Treasury Securities		228,209,154
Total Excluding Securities Lending & Securities Purchased But Not Settled		4,796,988,988
Securities Lending Investments, at amortized cost:		
Repurchase Agreements		143,940,964
Total Investments (Settlement Date Basis)		4,940,929,952
Due from Brokers - Securities Purchased But Not Settled, at Amortized Cost:		
U.S. Agency Discount Notes		199,678,972
Total Investments (Trade Date Basis)		5,140,608,924
Certificates of Deposit		377,386,161
Cash		10,332
Interest Receivable		4,515,949
Total Other Assets		381,912,442
Total Assets		5,522,521,366
Liabilities		
Accrued Expenses		211,542
Obligations under Securities Lending Agreement		143,940,964
Investment Trades Pending Payable		199,678,972
Total Liabilities		343,831,478
Net Assets	$	5,178,689,888
Participant Net Asset Value, Price per Unit	$	1.00
Total Amortized Cost - Settlement Date Basis	$	5,318,316,113

QUARTER AT A GLANCE
April 1, 2003 to June 30, 2003

Total investment purchases:	$	32,279,691,962
Total investment sales:	$	640,438,981
Total investment maturities:	$	31,164,180,000
Total net income:	$	15,970,056
Net of realized gains and losses:	$	220,531
Net Portfolio yield (360-day basis):		
	April	1.2381%
	May	1.2261%
	June	1.1904%
Average weighted days to maturity:		48 days

WASHINGTON STATE LOCAL GOVERNMENT INVESTMENT POOL
OFFICE OF THE STATE TREASURER
PO BOX 40200
OLYMPIA WA 98504-0200

RETURN SERVICE REQUESTED

PRSRT STD
U.S. Postage Paid
Olympia WA
Permit No. 179

Sunset Building, PO Box 40200, Olympia WA 98504-0200

Toll Free (800) 331-3284 * TDD (360) 902-8963 * FAX (360) 902-9044

Home Page http://tre.wa.gov